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7 February 1984

Memorandum for:

The attached typescript was prepared by [redacted] 25X1
[redacted] Iberia-Aegean Branch, at the request of 25X1
Robert M. Kimmitt, Executive Secretary, National Security Council.

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[redacted] Director, 25X1

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Office of European Analysis

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

7 February 1984

The Portuguese Request for Food Aid [redacted] 25X1

Summary

The Soares administration has shown considerable determination to carry out a stabilization program designed to solve Portugal's serious balance-of-payments problems. In response to the IMF's recommendations, the coalition government last year introduced a series of austerity measures and price hikes that cut into workers' real incomes and induced a recession. To meet the Fund's 1984 targets, Lisbon estimates that another round of price increases ranging from 50 to 70 percent is needed for basic foodstuffs. In view of the social strains such price hikes would produce, Lisbon has requested a one-time grant of agricultural commodity aid from the United States. This assistance could help Lisbon limit the size of food price hikes, mitigate worker unrest, and narrow the margin by which Portugal falls short of satisfying the IMF's demands. [redacted] 25X1

This memorandum was prepared by [redacted] Iberia-Aegean Branch, Western Europe Division, Office of European Analysis, at the request of Robert M. Kimmitt, Executive Secretary, National Security Council. It was coordinated with the Office of Global Issues. Questions and comments may be directed to the Chief, Iberia-Aegean Branch on [redacted] 25X1 25X1

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Recurrent International Financial Shortfalls

Portugal's most recent balance-of-payments problems began in 1977, when the current account deficit ballooned to $1.5 billion. The sudden shift from traditional surpluses to heavy deficits grew out of the fourfold increase in oil prices in 1974, the attempt to redistribute income after the 1974 revolution, and a worldwide downturn in trade. [redacted] 25X1

Portuguese authorities tried to finance the deficit by using hard currency reserves and borrowing from European central banks and multilateral institutions. Despite pledging half of its gold stock as security for loans and selling over $500 million worth of gold, Lisbon still had a large financing gap. It then turned to foreign governments for a bailout, and a consortium of 14 countries lent Lisbon a total of $750 million, of which the US contributed $300 million. At the same time, Portugal entered into an IMF stabilization program that swung the current account close to balance by sharply curtailing domestic demand. [redacted] 25X1

The improvement proved to be short-lived, as the 1980 oil price shock, policy errors, structural problems, and external factors again pushed Portugal toward bankruptcy. In 1981, the current account deficit reached $2.6 billion, largely reflecting a steep increase in the cost of oil imports. Although Lisbon succeeded in trimming the trade deficit in 1982, the current account deficit widened by $400 million because of a decline in worker remittances and tourism earnings. [redacted] 25X1

Although the effect of the government's misguided policies cannot be quantified, we believe they unquestionably contributed to Portugal's deteriorating external position. The Portuguese authorities hurt export competitiveness by revaluing the escudo in 1980 and then holding the monthly rate of depreciation below the differential between Portugal's rate of inflation and the rates of its major trading partners. Imports, on the other hand, remained buoyant because of a continuing rapid growth of domestic demand -- up 16 percent in real terms from 1980 to 1982, compared with the OECD average of about 1 percent. Meanwhile, Lisbon's decision to let real interest rates become increasingly negative discouraged workers abroad from repatriating their savings and prompted exporters and hotel owners to transfer their earnings overseas illegally. [redacted] 25X1

Domestically, Lisbon's unwillingness to raise food prices pushed the government's Supply Fund deeply into the red. The Supply Fund's purpose is to subsidize essential commodities such as cereals, fertilizers, and fuel oil by absorbing part of the import costs paid by monopoly state importers. It is supposed to cover these costs with revenue obtained from taxes on petroleum products, but the increasing subsidization of foodstuffs and fuel oil has required ever-larger transfers from the state budget. This has added to Lisbon's burgeoning budget deficit and weakened the financial health of the major public enterprises. As total outlays continued to surpass revenues, the

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Supply Fund amassed arrearages to the state-owned enterprises amounting to about $850 million between 1975 and 1982. 25X1

1983: A Year of Austerity and Financial Uncertainty

In the spring of 1983, the caretaker government pushed through a number of measures to cut domestic demand. These included substantial tax hikes; price increases of 15 to 30 percent for fuel, transportation, and electricity; and tripling the import surcharge. Prodded by the IMF, the caretaker government also devalued the escudo by 2 percent, raised the monthly rate of depreciation to 1 percent, and boosted interest rates. 25X1

In view of the caretaker government's lack of authority to negotiate an IMF agreement and the country's uncertain political prospects, international bankers last year were unwilling to increase their exposure in Portugal. As foreign credit dried up, hard currency reserves dwindled to less than one week of imports, and Lisbon was forced last summer to sell $700 million of its gold through the Bank for International Settlements. 25X1

The Socialist-Social Democratic coalition that took office in June moved immediately to correct internal and external imbalances. Measures included a 12-percent devaluation of the escudo; 11- to 30-percent price hikes for petroleum products; and substantial price increases for basic foodstuffs, including wheat (50 percent), corn (55 percent), vegetable oils (58 percent), and bread (22 to 24 percent). 25X1

The IMF Agreement

In order to regain access to commercial loans and to ease its foreign exchange shortage, the Soares government quickly concluded negotiations in August with the IMF for a $480 million standby loan. The terms of the agreement include:

- Limiting the current account deficit to $2 billion in 1983 and $1.25 billion in 1984.
- Reducing the combined deficit of the government and the Supply Fund from 12.6 percent of GDP in 1982 to 6 percent in 1984.
- Holding foreign debt to $14.6 billion in 1983 and to $16 billion in 1984.
- Reducing consumer price inflation to 20 percent by the end of 1984.

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- o Introducing substantial new price increases at the beginning of 1984 to eliminate subsidies on cereals and vegetable oils and to ensure that the Supply Fund shows a surplus.

- o Reforming public sector enterprises and raising prices of manufactured goods to reflect production costs.

- o Holding public sector wage gains down to 20 percent in both 1983 and 1984. 25X1

Lisbon met or surpassed all of its 1983 targets, according to preliminary figures. In particular, the current account deficit was cut in half to about $1.6 billion. Part of this spectacular improvement was illusory in that it stemmed from the drawdown of petroleum and agricultural stocks. Other factors included the imposition of quotas, delays in granting import licenses, difficulties in obtaining financing, and a downturn in economic growth during the second half of the year. The better-than-expected external performance helped Lisbon stay within the IMF ceilings on total foreign and short-term debt and to improve its debt structure. Foreign debt increased only slightly to $13.8 to $13.9 billion, while short-term debt dropped from about $4 billion to $3.4 to $3.5 billion. Short-term debt now represents about 25 percent of total debt, compared with 28 percent in 1982. Lisbon also hit its budget target by passing a one-time 2-percent tax on fourth-quarter incomes and raising taxes on gambling, automobiles, real estate, and stamps. 25X1

Prospects for Meeting 1984 Goals

We expect Lisbon's current account deficit to continue to improve this year. Given that Lisbon's tight domestic credit ceilings, public investment cutbacks, and higher taxes will cut real domestic demand by at least 4 percent, import demand should slacken. The extent to which Lisbon will have to resort to additional administrative measures to pare its import bill depends to a considerable extent on the performance of exports and invisibles. Gains in export competitiveness last year and the incipient economic recovery in Western Europe should spur export growth. Worker remittances, however, have not yet responded to the devaluation and higher interest rates announced last year. They may be down further in 1984 because of the return of emigrant workers to Portugal and because the strong US dollar has cut the dollar value of remittances from West European countries. 25X1

Given the Soares administration's reluctance to increase prices of basic foodstuffs by more than 10 to 15 percent and assuming that the US does not provide aid, Lisbon will fall well short of meeting its obligations under the standby agreement. Because of rising agricultural commodity prices on world markets and the depreciation of the escudo against the US dollar, heavy subsidies on basic foodstuffs have re-emerged. Lisbon estimates that it would have to raise wheat prices 50 percent, corn 72 percent, sunflower oil 55 percent, and rice 50 percent to eliminate the subsidies. We calculate that

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prices for other cereals, such as barley and sorghum, would also have to be increased by up to 75 percent to bring domestic prices into line with international prices. [redacted] 25X1

Because of the price imbalance, the Supply Fund is again operating in the red. [redacted] 25X1 even if it imposed a 30-percent average price hike for agricultural commodities, the Supply Fund would still run a deficit this year -- which we estimate at 1.3 percent of GDP. In fact, this figure is probably understated because Lisbon used the current exchange rate instead of a 1984 annual average in its computations. We estimate that the combined deficits of the Supply Fund and the government in 1984 may exceed 9 percent of GDP -- far above the IMF's 6-percent target. In addition, the deficit on the Supply Fund will prevent Lisbon from fulfilling its promise to pay back part of the arrears owed to public sector enterprises. [redacted] 25X1

If Commodity Credit Corporation (CCC) credits are held to the presently allocated level of $386 million, Lisbon probably would have to increase its short-term debt. Last year, the Portuguese estimated that the total cost of imports of wheat, feedgrains, rice, oilseeds, tallow, and cotton would come to about $850 million. Embassy reporting indicates that while Lisbon may have overestimated the volume of such imports, it underestimated the dollar value. To fill the gap between the food import bill and CCC credits, Lisbon would almost certainly have to seek more expensive short-term supplier credits. The higher interest costs would push the Supply Fund further into the red, while the increase in short-term debt would reverse Lisbon's past success in improving the structure of its debt portfolio. Lisbon could increase short-term debt by as much as $700 to $800 million in 1984 without exceeding the IMF ceilings. However, the Fund -- counting on $620 million in CCC credits -- had foreseen only a $200-million rise. [redacted] 25X1

Adjustment of the 1984 Targets

According to the Embassy, the IMF team is considering changing the targets for the current account deficit and the budget deficit. In the Fund's view, lower-than-anticipated capital inflows last year and the tightness of the international financial market suggest that even a deficit of $1.25 billion may not be financeable. [redacted] 25X1

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Political Pressures

Forthcoming economic reforms are likely to precipitate a flareup in strike activity. According to a former Portuguese official who now acts as an

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adviser to the World Bank, the Bank will press Lisbon to rationalize the overstaffed and shaky public enterprises in exchange for a $150 million Structural Adjustment Loan this spring. According to press reports, public sector companies are 30 to 40 percent overmanned. While we expect that the Portuguese probably will not cut public sector employment this sharply, the potential layoffs are unprecedented in a country where workers have been virtually guaranteed a lifetime job. Since the Communist-led trade unions have strong support from the laborers in the heavy industries that are most likely to be restructured, any attempt to lay off large numbers of workers would, we expect, bring workers into the streets to resist the change in policy. [redacted] 25X1

In our view, the daunting task of carrying out sweeping reforms and adhering to IMF and World Bank terms would be made even more difficult if Lisbon were to raise food prices immediately by 50 to 75 percent. Such a price shock might push the consumer price index up another 5 percentage points, and workers -- whose real wages are now lower than before the revolution -- probably would not acquiesce. While we believe the specter of food riots has been exaggerated to draw US sympathy, it is likely that Lisbon would find it difficult to keep public sector wage increases within the IMF guidelines under these circumstances. Moreover, stronger worker unrest would add strains to the coalition that could break it, given the hard feelings left over from the abortion issue. [redacted] 25X1

In our judgment, Lisbon is likely to impose an initial 10 to 15 percent price hike, followed by periodic price increases during the year. This would be less likely to play into the Communist trade unions' hands. Sporadic strikes are likely and Lisbon will probably have to exceed its wage guidelines, but we expect that this would create less tension within the coalition and would be less likely to weaken its resolve to cure Portugal's problems. If -- as seems likely -- agricultural commodity prices continue to rise, further price adjustments would be needed if US aid were really to be a one-time offer. [redacted] 25X1

Alternative Sources of Aid

The Soares administration might be able to further reduce import costs by turning to the EC. Portuguese officials indicated last year to Embassy officers that they would probably boost imports of cheaper EC imports if US credits fell short of their needs. Lisbon may also present a request for food aid to the EC. In view of Portugal's level of development and as yet undisclosed EC financial plans to assist Portugal during accession, the Ten probably would not be willing to provide grant aid. Because of the political payoffs, however, the EC might give a plea for soft credit terms a sympathetic hearing. This would help reduce interest costs and price imbalances, but would not eliminate subsidization by the Supply Fund. [redacted] 25X1

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TABLE 1
Portugal: Balance of Payments

Million US $

	1974	1975	1976	1977	1978	1979	1980	1981*	1982*	1983	1984
Trade balance	-2002	-1674	-2175	-2532	-2408	-2632	-4206	-5194	-4853	-2900	-2200
Exports, f.o.b.	2303	1940	1790	2001	2379	3550	4575	4088	4119	4650	5050
Imports, f.o.b.	4305	3614	3965	4533	4787	6182	8781	9282	8972	7550	7250
Invisibles	1173	855	886	1037	1582	2580	2948	2344	1614	1300	1200
Of which:											
Net tourism	259	101	182	266	431	695	859	777	611	600	650
Worker remittances	949	821	907	1174	1671	2455	2928	2832	2599	2300	2100
Interest payments	NA	NA	NA	-142	-387	-536	-733	-1099	-1337	-1350	-1400
Other	NA	NA	NA	-261	-133	-34	-106	-166	-259	-250	-150
Current account balance	-829	-819	-1289	-1495	-826	-52	-1258	-2850	-3239	-1600	-1000

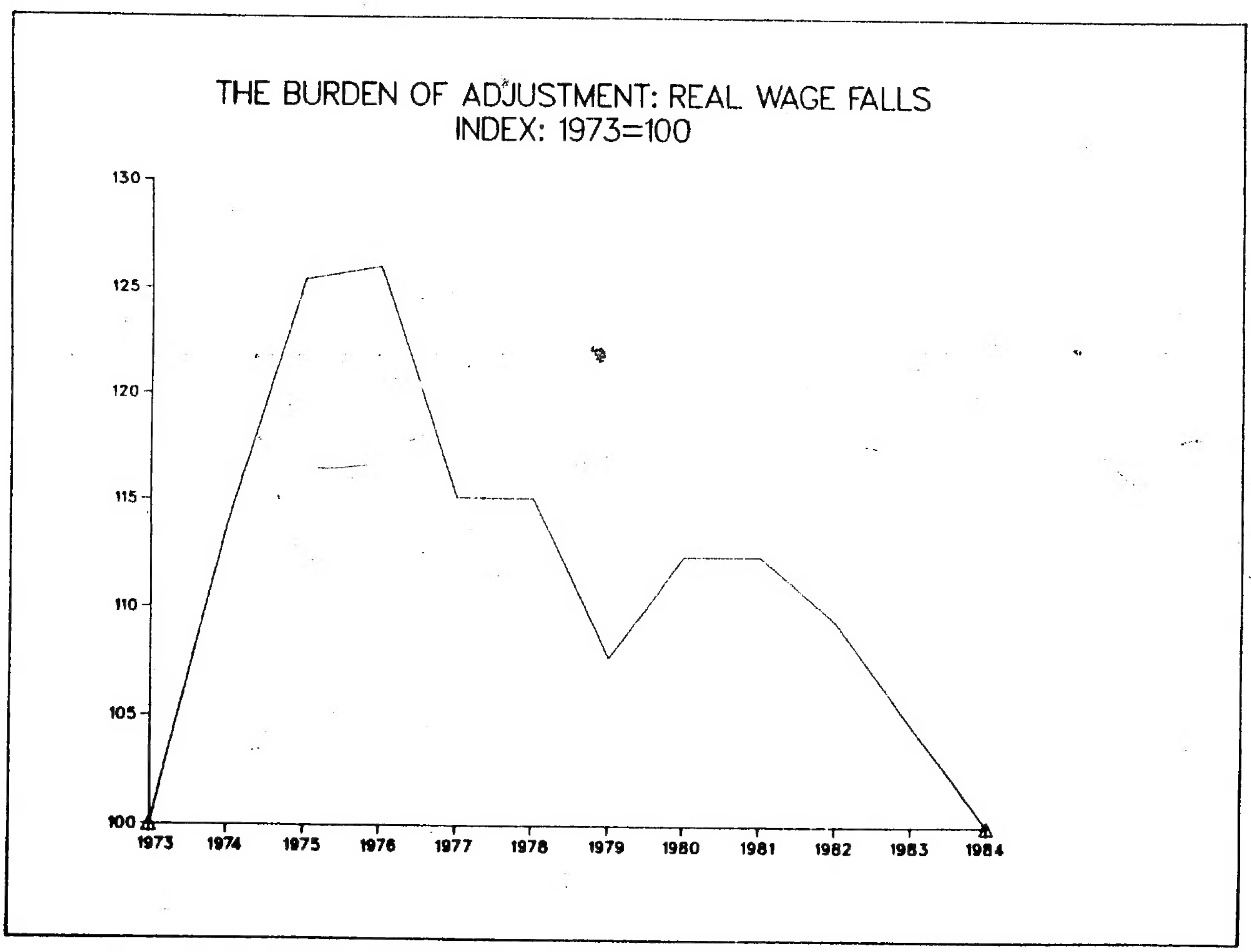
THE BURDEN OF ADJUSTMENT: REAL WAGE FALLS
INDEX: 1973=100
130
125
120
115
110
105
100
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984

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TABLE II

US Credit Availabilities to Portugal*

Million US $

	1976	1977	1978	1979	1980	1981	1982	1983	1984
GSM-102	65.0	118.6	206.2	148.6	52.0	175.0	425.0	550.0	386.0
Feedgrains	42.3	79.3	107.7	74.4	26.0	74.0	240.0	260.0	235.0
Wheat	6.0	32.2	37.1	22.0	10.0	26.0	60.0	73.0	117.0
Oilseeds	10.0	0	21.0	9.0	5.0	49.0	125.0	212.0	0
Cotton	5.2	0	12.0	0	0	.0	0	0	5.0
Tallow	1.5	4.0	2.0	2.0	1.0	0	0	0	8.0
Dairy cattle	0	3.1	2.2	0	0	0	0	0	0
Breeding swine	0	0	0	0.2	0	0	0	0	0
Rice	0	0	10.2	5.0	2.0	0	0	5.0	21.0
Protein meals	0	0	14.0	24.0	8.0	26.0	0	0	0
PL-480	25.0	70.0	40.0	40.0	29.0	11.0	NA	NA	NA
Corn/Sorghum	0	12.6	10.2	25.4	24.0	6.0			
Wheat	0	14.6	26.0	14.6	5.0	5.0			
Cotton	5.0	7.6	0	0	0	0			
Rice	20.0	18.2	3.8	0	0	0			
Tobacco	0	4.4	0	0	0	0			
Feedgrains	0	12.6	0	0	0	0			
Blended credits	NA	NA	NA	NA	NA	NA	NA	70.0	NA
Cotton								5.0	
Feedgrains								30.0	
Oilseeds								15.0	
Wheat								20.0	
Total	90.0	188.6	246.2	188.6	81.0	186.0	425.0	620.0	386.0

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